

October 29, 2013

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File Reference No. S7-14-11: SEC Proposed Rule, *Credit Risk Retention*

Dear Ms. Murphy:

Deloitte & Touche LLP appreciates the opportunity to comment on the proposed rule *Credit Risk Retention* that the SEC issued jointly with five other federal agencies¹ (the “agencies”) and that revises the agencies’ 2011 proposal to implement Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The proposed rule would require sponsors of securitization transactions (or their majority-owned affiliates) — except for securitization transactions of asset-backed securities (ABSs) that are collateralized exclusively by qualified residential mortgages² (QRMs) or other assets that the proposed rule specifically exempts — to retain credit risk in the securitized assets. Such sponsors could elect to retain credit risk on the basis of either an eligible vertical interest or an eligible horizontal residual interest (or any combination thereof) but must retain an amount equal to at least 5 percent of the fair value of all “ABS interests” in the issuing entity issued as part of the securitization transaction.

The fair value of the ABS interests in the issuing entity (including any interests that must be retained) must be determined (1) “as of the day on which the price of the ABS interests to be sold to third parties is determined” and (2) in accordance with U.S. GAAP. The proposal would also require sponsors to provide potential investors with certain information about how fair value was determined, including the method used, key inputs and assumptions, and other quantitative information.

¹ The Office of the Comptroller of the Currency, Treasury; the Board of Governors of the Federal Reserve System; the Federal Deposit Insurance Corporation; the Federal Housing Finance Agency; and the Department of Housing and Urban Development.

² As defined in the proposed rule.

Our comments on the proposal focus on three topics: (1) use of fair value to measure risk retention, (2) consolidation implications for securitization structures, and (3) whether an accountant's agreed-upon (AUP) procedures report would be issued in conjunction with the fair values to be reported by the sponsor.

Use of Fair Value to Measure Risk Retention

Although the proposal appears to conceptually equate fair value to intrinsic value,³ intrinsic value is a different standard of value than fair value under U.S. GAAP (i.e., ASC 820⁴). ASC 820-10-05-1B states, in part, that fair value is “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” Conversely, intrinsic value is the “true” or “fundamental” value of an asset after all available information about that asset is considered. An income approach, such as a discounted cash flows model, is typically used to estimate intrinsic value. Therefore, the proposal's indication that fair value would accurately reflect intrinsic value is not accurate because, under U.S. GAAP, (1) fair value must be measured at an “exit price” that maximizes the use of market-observable⁵ data (and minimizes the use of internal data) and (2) the use of other valuation techniques is allowed. We recommend that in the final rule, the SEC either eliminate the reference to intrinsic value or clarify that the two concepts are different.

APPROACHES TO MEASURING FAIR VALUE

ASC 820 does not prescribe use of a single valuation technique; thus, an entity may use different techniques — for example, the market approach, income approach, or cost approach — to measure fair value. However, we believe that the proposed rule contains language that could be interpreted as requiring a sponsor to use a specific valuation technique. For example, the proposed rule would require a sponsor to determine fair value “as of the day on which the price of the ABS interests to be sold to third parties is determined,” which implies that a market approach should be used. Conversely, the proposal also implies that sponsors would be required to use an income approach (i.e., discounted cash flow modeling) to measure the fair value of ABS interests (e.g., by requiring disclosure of information that would permit investors to assess

³ Page 340 of the proposal states, in part, that “[U]se of fair value accounting as a method of valuing risk retention also will provide a benefit to the extent that investors and sponsors can understand how much risk is being held and that the valuation methodology accurately reflects intrinsic value.”

⁴ FASB Accounting Standards Codification Topic 820, *Fair Value Measurements*.

⁵ Under ASC 820, an entity measures fair value on the basis of the observability of inputs and assumptions within a three-tiered hierarchy (from most to least observable) that market participants would use to value an asset. In an active market, available observable inputs, such as quoted prices for identical assets, are considered the best source and should be used to determine fair value (Level 1). When such observable inputs for identical assets do not exist, an entity should use valuation techniques that maximize the use of observable inputs, such as quoted prices for similar assets in active markets (Level 2). However, when observable inputs are not available, valuation techniques that employ assumptions and data that may not be verifiable (unobservable inputs) are used (Level 3).

the reasonableness of “key cash flow assumptions”).⁶ In addition, the proposal’s linkage to intrinsic value and, by extension, to a discounted cash flow method, may lead sponsors to conclude that an income approach is the only way to determine the ABS interest’s fair value.

We acknowledge that an income approach may often be the appropriate valuation technique to value ABS interests. However, we believe that if the final rule fails to clarify that sponsors are not restricted to an income approach, they may inappropriately believe that their ability to use observable inputs is limited. This seems especially inappropriate when they may be able to instead look to observable prices in the market as a better indicator of the fair value of ABS interests. In other words, without additional clarity, a sponsor may conclude that it could not use a market approach even if such an approach were more appropriate. Thus, the proposal is unclear on which method or methods a sponsor should use to determine the fair value of ABS interests.

Provided that the proposal does not preclude a sponsor from using a market price (if available), it may be difficult to identify the day on which the interests are priced because of the sequencing of events related to the structuring of ABS interests in a transaction and because ABS interests (1) are often priced over multiple days and (2) have multiple prices. The prices fluctuate because investors have differing views about the ABS interest’s intrinsic value at various points in time. For example, below-investment-grade investors often bid on classes before investment-grade investors do. In such instances, an eligible horizontal interest representing 5 percent of the fair value of all ABS interests cannot be determined until both types of investments have been priced. Because a sponsor will commonly receive numerous prices over more than one day, without additional guidance (1) the sponsor may be unable to choose a single price on a single day or (2) a lack of additional guidance would result in significant diversity in how the proposed rule’s requirements are applied. Therefore, we recommend that the final rule clarify how a sponsor should consider multiple prices over multiple days — e.g., whether sponsors should use the first price received at pricing or an average of prices received (weighted by principal balance sold).

As noted above, we disagree that fair value and intrinsic value are synonymous terms. We believe that if the agencies’ intent is for sponsors to determine fair value on the basis of the principles outlined in U.S. GAAP (i.e., ASC 820), (1) sponsors would use investors’ quotes received at pricing as an input to fair value because ASC 820 requires “valuation techniques used to measure fair value [to] maximize the use of relevant observable inputs”⁷ and (2) the agencies should consider clarifying in the final rule that sponsors are permitted to use such market inputs because, as observable inputs, they are likely to be better indicators of fair value.

⁶ Page 46 of the proposal notes that “[s]ponsors that elect to utilize the horizontal risk retention option must disclose the reference data set or other historical information which would meaningfully inform third parties of the reasonableness of the key cash flow assumptions underlying the measure of fair value. For the purposes of this requirement, key assumptions may include default, prepayment, and recovery. The agencies believe these key metrics will help investors assess whether the fair value measure used by the sponsor to determine the amount of its risk retention are comparable to market expectations.”

⁷ See ASC 820-10-35-36.

Consolidation Implications for Securitization Structures

The proposal may significantly affect the sponsor's financial reporting for its interests in securitization structures and whether sponsors are required to consolidate such securitization entities into their financial statements. ASC 810 currently requires entities involved with securitization structures (which are typically considered "variable interest entities") to consider whether they (1) have the power over the relevant activities of the entity (i.e., activities that significantly affect the entity's economic performance) and (2) are subject to potentially significant economic exposure (whether upside, downside, or both). In many cases, the sponsor of the securitization structure is considered to have the power over the relevant activities so that the conclusion about whether a sponsor consolidates a securitization structure will heavily depend on the economic-exposure criterion. The term "potentially significant" is not precisely defined in U.S. GAAP (i.e., it is not formulaic). As a result, the type of interest retained by the sponsor (vertical, horizontal, or a combination), in addition to any other financial interests (e.g., fee arrangements), could influence the consolidation decision. While it is difficult to draw any broad conclusions until the full details of the structure and retained interest are known, if the potential investors require sponsors to hold a horizontal rather than a vertical interest (or a combination), there is a greater risk that these structures would be subject to consolidation under current U.S. GAAP. Accordingly, we believe sponsors would find it useful if the final rule expressed the SEC's views, if any, about potential consolidation implications.

Use of an AUP Report in Conjunction With Fair Value

The proposed rule does not mandate AUP in conjunction with its risk retention requirements. However, the proposal seeks comment on whether accountants would be asked to perform AUP⁸ related to a sponsor's determination of the fair value of ABS interests. In response to the question, we do not believe that sponsors will request accountants to perform AUP on fair values or related information because of the restrictions on AUP reports that preclude third parties from relying on AUP. Therefore, we believe that sponsors will find AUP to be of limited usefulness in such a context.

The services provided by accountants to sponsors typically include the preparation of AUP reports. The standards under which AUP engagements are performed impose a number of requirements on the practitioner (service provider), the client, and other "specified parties." For instance, the report can only be used by the client and other specified parties that have agreed to the procedures performed and have taken responsibility for the sufficiency of those procedures

⁸ AUP engagements are performed in accordance with AICPA Statements on Standards for Attestation Engagements Nos. 10 and 11 under AICPA *Professional Standards*, AT Section 101, "Attest Engagements," and AT Section 201, "Agreed-Upon Procedures Engagements." In these engagements, procedures are performed according to established criteria that are agreed to and deemed sufficient by parties specified in the engagement agreement (typically the issuer or the underwriter), such as a comparison of numerical disclosures in the prospectus with certain underlying data.

for their own purposes. Because the specified parties take responsibility for the design and sufficiency of the procedures the accountant performs, the accountant does not issue an opinion with its AUP report as is done in an audit. Rather, the accountant reports the procedures it has performed and the results of those procedures. Thus, an AUP report prepared for a client and other specified parties is intended solely for their use.

Further, as professional standards recognize, it is necessary to restrict the use of AUP reports to help ensure that the findings are not taken out of context and misunderstood. For example, paragraph 79 of AT Section 101 states that “[t]he need for restriction on the use of a report may result from a number of circumstances, including the purpose of the report, the criteria used in preparation of the subject matter, the extent to which the procedures performed are known or understood, and the potential for the report to be misunderstood when taken out of the context in which it was intended to be used.” Indeed, AUP reports, by their very nature, are not suitable for use by investors or any other persons or entities that have not agreed to the procedures performed and taken responsibility for the sufficiency of procedures for their purposes. Confusion may result if the context of the findings and conclusions from these reports is not provided; for example, investors could infer certain assurances that may not be warranted. For these reasons, we agree that AUP should not be mandated and do not believe that sponsors would be likely to request AUP reports related to their computation of the fair value of ABS interests to be retained.

We appreciate your consideration of these matters and would welcome an opportunity to discuss them with you further. If you have any questions about our responses, please do not hesitate to contact Guy Sindle at 212-436-4269 or William Fellows at 415-783-5339.

Sincerely,

/s/ Deloitte & Touche LLP